No. 13138

United States Court of Appeals
For the Ninth Circuit

UNITED STATES OF AMERICA, *Appellant*,

— VS. —

PAT DUBY, doing business as Pat Duby Company, and CONTINENTAL CASUALTY COMPANY, a corporation, *Appellees*.

UPON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON
NORTHERN DIVISION
HONORABLE JOHN C. BOWEN, *Judge*

BRIEF OF APPELLEE

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BRIEF OF APPELLEE

SUPPLEMENT TO GOVERNMENT'S STATEMENT OF THE CASE

The government has fairly and accurately stated the facts of the case except that Appellee does not of course agree with the conclusions set forth in the last two paragraphs on page 4 of Appellant's brief. There are, however, some additional facts which should be brought to the attention of the court.

Prior to the awarding of the contract to Duby for the sum of $6,602.70, Pat Duby and his estimator examined the site of the job on or about August 15, 1944. The contract was for the construction of four concrete check dams and one twin-barrell concrete box culvert at Seattle-Tacoma Airport, which is just south of the City of Seattle. At the time of such examination, the

ground was normal and there was only a very small trickle flowing down the gulley wherein the construction was to be made (Tr. 123, 124).

The contract was let by the United States to Pat Duby and notice to proceed was given on October 6, 1944 (Ex. 5). Upon commencement of the work by Pat Duby, torrents of rain in unprecedented amounts descended upon the job (Tr. 126, 147) and the entire project became a sea of mud. As the excavation work commenced, quick-sand was encountered along the entire construction area (Tr. 126, 149-150). Pat Duby continued to carry out the terms of his contract despite the adverse elements and the greatly increased expense (Tr. 128-129) because he wanted to complete the job (Tr. 124). The government engineer superintending the work indicated that Duby would be awarded an extension of time and additional funds (Tr. 130).

Pat Duby expended in the performance of the contract a total sum of $17,687.02 (Ex. 14, Tr. 131) and in addition thereto, Continental Casualty Company, as surety upon the payment bond of Pat Duby paid to labor and material claimants the full amount of such payment bond in the sum of $3,397.00 (Defendant's Ex. A-2).

The government's claim in this action for liquidated damages at the rate of $20 per day commenced to accrue November 20, 1944, and terminated with the completion of the job on April 2, 1945 (Tr. 34-Findings, Paragraph VIII).

Contract payments were made by the government

to Pat Duby in installments as the work progressed. The first payment was made in December, 1944, and all remaining payments to the full extent of the contract were made subsequent to that date, except that out of the final settlement the government withheld from Pat Duby the sum of $979.82 as a partial offset against the liquidated damages claimed by the government (Tr. 133-134).

The United States was in no way damaged by the delay of Pat Duby in completing the contract (Tr. 85, 105).

Following the submission of briefs and full argument of the matter the trial court entered its Findings of Fact and Conclusions of Law (Tr. 31) and entered Judgment of Dismissal both as to Pat Duby and as to Continental Casualty Company (Tr. 40). Appellant in its opening brief has moved to dismiss its appeal as to Pat Duby.

ARGUMENT OF APPELLEE, CONTINENTAL CASUALTY COMPANY

Appellant having moved to dismiss from this appeal Appellee, Pat Duby, the arguments commencing with the last paragraph on page 17 of Appellant's brief and continuing through the middle of page 19 of Appellant's brief become immaterial and inapplicable to the issues on this appeal.

Continental Casualty Company does not contend nor take the position that it was released from liability as surety by virtue of Pat Duby's discharge in bankruptcy. It is clear under Section 16 of the Bankruptcy Act of 1938 that a surety is not released by

the discharge of its principal in bankruptcy and Continental Casualty Company does not so contend.

Appellant assigned as error only two particulars. The first is with reference to Finding XII to the effect that Continental Casualty Company had no notice of the government's claim for liquidated damages resulting from delay in the performance of the contract by Duby until September 11, 1946. Under the theory on which this case was tried on behalf of Continental Casualty Company such finding is immaterial and is unnecessary to support the judgment of dismissal. Nevertheless, Appellee is of the opinion that each and all of the Findings are fully supported by the evidence in the record.

The defense of Continental Casualty Company to the claim for liquidated damages by the government is twofold. First, the claim of the government is in the nature of a penalty and therefore not recoverable; and second, Continental Casualty Company as surety upon the performance bond of Pat Duby was released by the acts of the government. The trial court rendered its decision in favor of Continental Casualty Company under the latter point.

Liquidated Damages or Penalty

It is conceded that the authorities are in direct conflict on this particular question. Still, we believe that the better rule is that a clause in a contract calling for a penalty or liquidated damages will not be enforced where no damage whatever has been sustained. Nor will such clause be enforced where the sum named in the contract to be paid on a breach is wholly dispro-

portionate to the damage actually sustained. It will be observed that the total contract price was $6,602.70 and that the government's claim is for the sum of $2,660.00, which is in excess of 40% of the contract price. Such cases will deem the parties to have intended to stipulate for a mere penalty to secure performance.

The following authorities sustain this rule:

> *Rispin v. Midnight Oil Co.* (1923—Ninth Circuit) 291 Fed. 481, 34 A.L.R. 1331 at page 1334:

"The next point concerns the clause of the contract providing for liquidated damages. Keeping in mind that the complaint does not allege that plaintiff has suffered any damage, and that the defendant's answer expressly avers that plaintiff did not suffer any damage at all, it is not necessary to decide whether the clause is to be read as a penalty or as one for liquidated damages, for the reason that, even granting that it must be read as for liquidated damages, it will not be enforced were no damage whatever has been sustained. In *Northwest Fixture Co. v. Kilbourne & C. Co.*, 62 C.C.A. 638, 128 Fed. 256, this court considered an agreement which contained a provision that, in the event either party should fail to keep its agreement, the party thus in default should pay to the other party the sum of $10,000 as liquidated damages. Judge Gilbert, for the court, said: 'Conceding the rule to be that, in order to recover a sum as liquidated damages, it is unnecessary to prove actual damage, it is also true that no provision in a contract for the payment of a fixed sum as damages, whether stipulated for as a penalty or as liquidated damages,

will be enforced in a case where the court can see that no damages have been sustained. It is the general rule that, where the sum named in the contract to be paid on a breach thereof is evidently wholly disproportionate to the damage actually sustained, or where it is shown that no actual damage has been sustained by the breach the courts will deem the parties to have intended to stipulate for a mere penalty to secure performance'."

See also:

The Colombia, 197 Fed. 661;

Northwest Fixture Co. v. Kilbourne & Clark Co., 62 C.C.A. 638, 128 Fed. 256;

In re Gelino's, 43 F.(2d) 832.

Again the rule is well stated in 34 A.L.R., page 1336, as follows:

"The tendency and preference of the law is to regard a stipulation or covenant for the payment of a specified sum upon the breach of the contract as in the nature of a penalty, rather than as liquidated damages, since it may then be apportioned to the loss actually sustained, and compensation made according to justice and right; although, where the circumstances and the nature of the contract are such that actual damages cannot be ascertained with any degree of certainty, the stipulation will be regarded as one for liquidated damages. 8 R.C.L., p. 564, §114. Whether the loss actually suffered bears a reasonable proportion to the amount stipulated must be taken into consideration in determining if that amount is a penalty or liquidated damages, so that a sum stipulated, not disproportionate to the damages likely to result, is a stipulation for

> liquidated damages, while if the stipulation is so large as to be out of proportion to the probable or presumptive loss, it is regarded as a penalty, especially if the damage resulting may be easily ascertained, * * *."

The Surety Continental Casualty Company Was Released from Its Obligation Under Its Performance Bond by Acts of the Government.

I.

The government upon completion of the contract by Mr. Duby accepted the same as completed. Such acceptance without reserving its rights against the surety under the performance bond precludes the government's right to recover the penalty for delay.

The general rule set forth in 43 Am. Jur. 917, §178 (Public Works) is as follows:

> "It is the general rule that acceptance by the public authorities of work done under a construction contract prevents such public authorities from subsequently recovering upon the contractor's bond for any breach of contract in the absence of anything to show such acceptance and final settlementment were procured through fraud or mistake."

With reference to the question as to when Continental Casualty Company was first notified as to the possibility of a claim by the government for liquidated damages for delay by Duby in completing the contract, it must be remembered that in connection with this contract the surety, Continental Casualty Company, had also issued a payment bond. It was in this connection that Mr. Bruce wrote Exhibit 6, being a

letter dated March 6, 1945, to the Civil Aeronautics authorities asking that the government withhold further progress payments or settlement funds from Mr. Duby. The government answered (Exhibit 6) by letter dated April 19, 1945, advising that the inspection of work contracted for had been made and the work accepted. The government did not in such letter or in any other letter until Exhibit 18-B (dated September 11, 1946), advise Continental Casualty Company of its claim for liquidated damages. This is further borne out by letter Exhibit 18-A. Mr. Bruce's testimony (Tr. 158) is to the effect that the first notice which he had of any claim by the government for liquidated damages was contained in Exhibit 18-B, letter of September 11, 1946.

The effect of the government's failure to notify Continental Casualty Company of this purported claim for liquidated damages until almost a year and a half after the completion and acceptance of the work was to greatly prejudice the surety in view of the fact that in the meantime the principal, Pat Duby, went into bankruptcy and the surety not knowing of the government's claim did not file a claim in the bankruptcy proceeding for this particular item. The bankruptcy file will show a claim by Continental Casualty Company but that was for reimbursement for payment made under its payment bond to laborers and materialmen.

In this connection, we cite *Munroe v. National Surety Co.*, 47 Wash. 488, 92 Pac. 280, wherein it is stated at page 491 as follows:

"This court has repeatedly held that a failure

> to give notice in this class of cases is only a defense in so far as the surety has been damaged or prejudiced by such failure. *Heffernan v. United States Fidelity, etc.*, 37 Wash. 477, 79 Pac. 195; *Trinity Parish v. Aetna Indemnity Co.*, 37 Wash. 515, 70 Pac. 1097; *Denny v. Spurr*, 38 Wash. 347, 80 Pac. 541. In the case at bar the contract was to be completed on or before September 15th, and the first notice of default was given November 22d. Failure to give notice at an earlier date would release the bonding company from any claim for demurrage or for failure to complete the building on time, but not for damages arising from lien claims for labor or material. Cases above cited."

It appears to us that the government's position from a legal, moral and equitable standpoint is without foundation. The government received a completed job into which was poured in excess of $20,000 by the contractor, Pat Duby, and the surety upon his payment bond. The job was completed by the contractor despite adverse weather conditions and the encountering of quicksand for all of which the government paid only the contract price of $6,602.70. It would seem hardly fair or equitable that under the circumstances that the government now be allowed to recover liquidated damages for delay in the completion of the contract.

II.

The government is claiming a penalty of $20 per day for delay in completion of the contract from November 20, 1944, until April 2, 1945. The evidence is undisputed that the first payment under the contract

was made in December, 1944, which, of course, is subsequent to the date on which the government claims the liquidated damages began to accrue. *During all of the time from December, 1944, until the completion and acceptance of the contract the government was making payments as the work progressed to the contractor, Pat Duby. Yet at no time did the government exercise its right to withhold and set off the amount of the penalty as the same accrued against the progress payments, all to the prejudice of the surety, Continental Casualty Company. The failure of the government to exercise its right to set off and withhold payments to the contractor prejudiced the rights of the surety, particularly, in view of the fact that during the interim the contractor became insolvent and went into bankruptcy.*

The rule which releases the surety under such circumstances is clearly set forth in 50 Am. Jur. 976, §109, wherein it is stated:

> "A surety is entitled to be subrogated to the benefit of all the securities and means of payment under the creditor's control, and so, in the absence of assent, waiver, or estoppel, he is generally released by any act of the creditor which deprives him of such right. The creditor must for a surety's benefit apply to his debt all moneys and securities of the principal within his control which he has the right to apply, and if he voluntarily surrenders or releases the same, the surety is discharged *pro tanto*." (Citing many cases)

The rule is again well stated in the annotation found in 115 Am. St. Rep. 95, as follows:

> "It is the duty of the creditor where he holds

property of the principal in his possession as security for the principal's obligation, not to release such property upon penalty of discharging the surety to the extent of the property so released. The position of the creditor under such circumstances is in the nature of a trustee for all parties (citing many cases) * * *

"A surety upon the bond given as indemnity against defective work under the construction contract can only be released by some positive act done by the owner to the prejudice of the surety such as acceptance and payment with knowledge of some act which would imply connivance amounting to fraud (citing cases). Positive acts of negligence on the part of the creditor in making payments which he had the right under a building contract to withhold will in some cases release the surety (citing cases) * * *

"Hence the general rule is that where the creditor has within his control funds of the principal debtor which may properly be applied to the payment of the obligation, but fails to do so, the surety is discharged (citing cases)."

In *Brown v. First National Bank*, 132 Fed. 450, at page 455, the court said:

"The wrongful surrender of collateral security by a creditor without the knowledge of the sureties for the payment of the debt discharged them from liability therefor entirely or *pro tanto* according to the value of the security thus surrendered."

The element of estoppel enters into the application of the foregoing rules as it is only just and proper that where the creditor had the right and opportunity to withhold funds in its hands but pays them over to

the principal and later makes a claim against the surety, the equitable principle of estoppel enters for the protection of the surety.

In this connection the rule is well stated in 50 Am. Jur. 975, §108:

> "The doctrine of estoppel may, in proper circumstances, be invoked to prevent a creditor from asserting any liability against the surety, as where the surety, relying upon a statement of the creditor that the debt has been paid, is induced thereby to change his position, to his injury, or where the creditor releases the surety, or leads him to believe that he has been released, and thereby induces him to release the principal, or to forego taking steps to protect himself against loss on his contract of suretyship."

The foregoing rules were applied in a charge to the jury and affirmed by the Supreme Court of Oklahoma (1913) in the case of *Johnson v. Jones*, 135 Pac. 12 (Headnote 2).

These rules are recognized by the Restatement of the Law of "Security," Chapter 5, Paragraph 132, wherein it is stated:

> "If the creditor surrenders the security or impairs its value, he loses or diminishes the value of an asset which might otherwise be used to satisfy his claim against the principal, and reduces the value of the security to which the surety is entitled upon his own performance. The surety is consequently entitled to a reduction in his obligation to the extent of the value of the lost security."

The Washington State Supreme Court likewise adheres to the foregoing rules. In the case of *City of*

Tacoma v. Peterson, 174 Wash. 621, the court states at page 625 (25 P.(2d) 1034):

> "The respondent surety, upon the other hand, urges that it is a well-settled rule at law that, when the rights of a surety are involved, the obligee must deduct from the payments any sum owing to it, otherwise the surety will be discharged, citing *Wood v. Brown*, 104 Fed. 203; *Commonwealth v. Vanderslice*, 8 Serg. & Raw. (Pa.) 451; *Clow v. Derby Coal Co.*, 98 Pa. 432, and a considerable number of cases from other courts that seem to so hold.
>
> "While we are satisfied that this is the general rule and the correct rule to apply in this case, we have another reason for applying it, * * *."

The rules above cited releasing the surety under circumstances as are present in this case are in the nature of estoppel.

The principle of estoppel is applicable against the United States government when such government is acting in its proprietary capacity. In the present case the United States government acting through the Civil Aeronautics Administration contracted with defendant, Duby, for the construction of four concrete check dams and one twin barrel concrete box culvert near the Seattle-Tacoma Airport at Seattle. The contracting for the control of drainage in a local area is certainly acting within its proprietary capacity and has no relation to governmental functions. The rule is stated in 19 Am. Jur. 922, §169 as follows:

> "So far, however, as the United States acts in a proprietary capacity or enters into contractual relationship, an estoppel may be exerted against it provided the functions of the govern-

ment are not impaired thereby. In other words, the law of estoppel in a proper cases applies to the government."

Branson v. Wirth, 17 Wall. (U.S.) 32.

CONCLUSION

It is apparent that the surety, Continental Casualty Company, has been discharged by reason of the government's acts in failing to withhold for its own benefit payments which were being made to Pat Duby at the very time that the government purported to be claiming a penalty for delay in the performance of the contract. Under the rules stated above such acts on the part of the government constitute a discharge of the surety under its bond and this court should affirm the decision of the trial court in that regard.

Respectfully submitted,

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